# Sales Tax on Services & Double-Direct Test

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Indiana is the most manufacturing-intensive state in the U.S.

- 30 percent of Indiana gross domestic product (GDP) is directly attributable to manufacturing
- 17 percent of the Hoosier workforce is employed by manufacturers
- In January 2014, Indiana reached 500,000 Hoosiers employed in the manufacturing sector for the first time since October 2008.
- Indiana has added over 77,000 manufacturing jobs since July 2009 – second most in the U.S.
- Hoosier manufacturers pay, on average, $30,000 more in compensation (wages & benefits) to their employees than other private sector employers.

1. **Sales Tax on Services**:

a. *Use as "Replacement Revenue" for Personal Property Tax Relief.* The current IMA tax policy considers expanding the sales tax base to services as a funding source (i.e., "replacement revenue") to repeal the personal property tax on production machinery and equipment, or as an alternative, to repeal the 30 percent minimum valuation floor on personal property. Additionally, although not an official IMA position, many of our members have expressed that any expansion of the sales tax base to services should also be used to reduce the current 7 percent sales tax rate to 5 percent or 6 percent.

You may be asking: "why should individuals pay a sales tax on services to pay for personal property tax relief for manufacturers?" As stated above, manufacturing is the primary driver of our state's economy that provides high-paying jobs for families. Families benefit – everyone benefits – if the Hoosier manufacturing sector grows. Business expansion and new investment is more likely if the personal property tax on production machinery and equipment or, as an alternative, the 30 percent minimum valuation floor, is repealed.

b. *Bipartisan Support.* Liberal, moderate, and conservative think tanks support taxing services. The Center on Budget and Policy Priorities, Institute on Taxation and Economic Policy, Tax Foundation, Council on State Taxation (COST), and the Manhattan Institute have recently published papers or articles supporting taxing services.

c. *Indiana More Service-Based Economy.* According to data from the U.S. Bureau of Economic Analysis, in 1965, manufacturing was responsible for creating 42 percent of Indiana's total gross domestic product. Today it is 30 percent. Service industries accounted for 17 percent of GDP in 1965 and 34 percent today. Clearly, Indiana has become a more service-based economy; yet most of these services are not taxed. Through our current sales taxation policies, there is an incentive to grow our service-based economy by exempting them from the sales tax while creating disincentives for manufacturers by taxing their final product with a 7 percent tax.

d. *End All Sales Taxation of Business Inputs.* If the sales tax base is expanded, services consumed by businesses in the process of producing goods and services should be exempt. According to an April 2013 national study by COST, over 40 percent of state sales taxes are collected from taxation of business inputs. In Indiana, about 30 percent of business inputs are currently taxed. Ernst & Young, *What's Wrong with Taxing Business Services?* April 4, 2013

Business inputs should be exempt from the sales tax not because businesses deserve special treatment, but because failure to do so results in "tax pyramiding." Taxing these services will make sales taxes more unfair because business-to-business sales taxes are ultimately passed through to consumers. These passed-through taxes are invisible to the consumer in the form of higher consumer prices.

2. **Double-Direct Test**

a. *Shipping versus Packaging*. I receive more calls from our IMA membership about Department of Revenue audits and the application of the "double direct" test than any other issue. The specific audit issue most discussed is the interpretation of "shipping versus packaging" in Department of Revenue rules. Equipment purchased for the purposes of "packaging" is exempt from the sales tax as the end point of production where the item has been altered to its complete form. However, items for "shipping" is taxable. 45 IAC 2.2-5-8(d).

b. *Indiana is Only Double Direct State*. Indiana is the only state that applies a "double direct" test to determine whether the purchase of machinery, equipment, or tools by a manufacturer is exempt from the sales tax. What is the "double direct" test? In Indiana, for a purchase of equipment, tools, or machinery to be exempt from the 7 percent sales tax, a manufacturer must prove it acquired the item for "direct use in the direct production" of other tangible personal property. IC 6-2.5-5-3; 45 IAC 2.2-5-8.

c. *Repeal and Replace Test*. In order to not apply the sales tax to the purchase of business inputs, the "double direct" test needs to be repealed and replaced with a much simpler test. Professor Mikesell's whitepaper provides an idea for a much simpler test: "was the purchase made by a business as an input to the operations of that business?"